The following discussion and analysis should be read together with Elbit Systems' audited consolidated financial statements and notes for the year ended December 31,2002 (the "Financial Statements") attached hereto.

GENERAL

Critical Accounting Policies and Estimates

For a description of our significant accounting policies - see Note 2 (Significant Accounting Policies) to the Financial Statements .

Our results of operations and financial condition are based on the preparation of consolidated financial statements in conformity with U.S. GAAP. The preparation of the consolidated financial statements requires management to select accounting policies for critical accounting areas as well as estimates and assumptions that affect the amounts reported in the financial statements. Significant changes in assumptions or conditions and changes in critical accounting policies could materially impact our operating results and financial condition.

We believe our most critical accounting policy relates to revenue recognition based on SOP 81-1 "Accounting for Performance of Construction Type and Certain Production Type Contracts", which is relevant to most of our revenues.

Under SOP 81-1, we adopted the "percentage of completion" accounting method. Under this method, we recognize revenues and profits on long-term fixed price contracts generally based on estimates of costs to be incurred for the total contract. Under this approach, we compare estimated costs to complete an entire contract to total revenues for the term of the contract to arrive at an estimated gross margin percentage for each contract. The estimated gross margin percentage is applied to the cumulative revenue recognized on the contract to arrive at cost of sales for the period.

Management reviews these estimates periodically, and the effect of any change in the estimated gross margin percentage for a contract is reflected in cost of sales in the period in which the change becomes known. If increases in projected costs to complete are sufficient to create a loss contract, the entire estimated loss is charged to operations in the period the loss first becomes known.

A number of internal and external factors affect our cost estimates, including labor rates, estimated future material prices, revised estimates of uncompleted work, efficiency variances, linkage to indices and exchange rates, customer specifications and testing requirement changes. If any of the above factors were to change, or if different assumptions were used in the application of this and other accounting policies, it is likely that materially different amounts would be reported in our consolidated financial statements.

Impairment of Goodwill and Other Long-Lived Assets

Consistent with Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets," goodwill is not amortized and is tested at least annually for impairment. Prior to 2002, goodwill was amortized using the straight-line method over its estimated period of useful life. As of December 31, 2002, our goodwill and assembled work force amounted to $32.5 million.

Based on the results of a goodwill impairment evaluation that was made during the fourth quarter of 2002, we concluded that no impairment loss was required to be recorded in 2002.

Consistent with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," we evaluate long-lived assets for impairment and assess their recoverability based upon anticipated future cash flows. We concluded that no impairment loss was required to be recorded in 2002. As of December 31, 2002, our long-lived assets amounted to $276.2 million, including $73.2 million in intangible assets.

Should future impairment tests we make determine impairment in the value of our goodwill or long-lived assets, this may have a material effect on our financial results in the period in which the impairment is determined.

Investment in Affiliates, Partnership and Other Entities.

We evaluate investments in affiliates, partnerships and other entities. When relevant factors indicate an other than temporary decline in the fair value of these investments below their book values, we adjust the investment to the estimated fair value. The value of these entities is subject to ongoing changes resulting from their business conditions. In the fourth quarter of 2002, we wrote-off $2.0 million representing our investment in Red C in which El-Op owns an approximately 38% interest.

Backlog

Our backlog includes firm orders received from customers for systems, products and projects that have yet to be completed. Our policy is to include orders in our backlog only when specific conditions are met. Examples of these conditions may include, among others, proof of funding, receipt of advances, letters of credit and guarantees from customers. As a result, in recent years the actual amount of our remaining unfilled orders generally has exceeded the level of backlog.

We reduce system and product backlog on delivery or acceptance. We reduce project backlog as contract milestones or engineering progress under the long-term contracts are recognized as achieved. In some cases we reduce project backlog when costs are incurred. The method of backlog recognition used often changes depending on the particular contract. As of December 31, 2002, we had a backlog of approximately $1,689 million, of which 62% was for orders outside Israel, as opposed to $1,566 million, of which 68% was for orders outside of Israel, as of December 31, 2001. Backlog information and any comparisons of backlog as of different dates may not necessarily represent an indication of future sales.

TRENDS

Since the terrorist attack on the World Trade Center in New York on September 11, 2001, increased terrorist activities and recent hostilities in Afghanistan and Iraq have caused many of our defense customers to shift their priorities. Although the number of recent platform upgrade programs has not grown, increasing attention is being given to ISR, as well as perimeter and homeland security issues. This in turn leads to a greater focus on C^4I related systems and UAVs. Although there is no assurance, we believe that our systems, products and capabilities position us to meet the emerging needs of customers in many of these areas.

OPERATING RESULTS

The Impact of the Merger on the Financial Results

We completed our Merger with El-Op in July 2000. Major Shareholders and Related Party Transactions – Related Party Transactions – Agreements Related to the Merger. The Merger was accounted for under the purchase method. The $180 million purchase amount exceeded the book value of El-Op by $130 million. Of the excess, $21 million was attributed to the fair value of the identifiable tangible assets, net of $4 million in deferred taxes. The balance, in the amount of $109 million, was attributed to intangible assets, net of $14 million in deferred taxes.

In accordance with an independent appraisal, approximately $40 million of the purchase amount was allocated to in-process research and development projects and was written off immediately at the time of the Merger. This allocation represented the estimated fair value of incomplete research and development projects, which at the time of the Merger had not yet reached technological feasibility and where the research and development in progress had no alternative future uses.

The present value allocated to the projects was determined, among other factors, on the basis of the estimated discounted future net cash flows which would be generated from the projects if they were to reach commercial feasibility, based on their development stage as of the date of analysis. The projects included in the analysis were mainly projects that were, at the Merger date, in different stages of design, development, engineering and testing activities. The projects were primarily in the areas of thermal imaging (night vision), lasers, avionics, battlefield management, fire control systems, remote sensing, airborne and UAV reconnaissance, enhanced landing systems and other classified projects.

The balance of the cost attributed to intangible assets was allocated as follows - $58 million to developed technology and know-how, trade names and assembled workforce, net of $14 million in deferred taxes, and $25 million to goodwill. The amounts allocated to intangible assets will be amortized on a straight line basis over their seven to 25-year estimated life. The weighted average period of amortization for the intangible assets was determined to be 17 years, and the amortization will be reflected in the cost of sales and in the general and administrative expenses. Due to allocation to group companies of intangibles acquired that are subject to different tax rates and tax liabilities attributed to some foreign subsidiaries at the date of the purchase, Elbit Systems recorded additional goodwill and deferred tax liability in the amount of $4.2 million.

For proforma financial information regarding Elbit Systems and El-Op see Note 1(C) to the Financial Statements .

Restructuring Program

Following the completion of the Merger in the third quarter of 2000, we adopted a program for organizational changes aimed at increasing the efficiency and maximizing the utilization of the resources at our disposal and the synergies resulting from the Merger. As part of this program, the combat vehicle activities of Elbit Systems were transferred to El-Op, the UAV activities of Elbit Systems and El-Op were combined into Silver Arrow, and the U.S. operations were reorganized under EFW.

In the third quarter of 2000, we began implementation of the reorganization and cost reduction plan. The plan includes, among other things, the consolidation of duplicate activities, adjustments in some of Elbit Systems' and our subsidiaries' fixed assets, employment terminations and write-offs of duplicate inventories and equipment and other related expenses. Pursuant to the plan, we wrote-off inventories in the amount of $10.3 million and equipment in the amount of $5.1 million. The equipment will not be used by us in the future since it is less efficient than other equipment held by us. We also accrued and paid $3.2 million for employment terminations of a total of 61 manufacturing, marketing and corporate employees both in Israel and the U.S., and $3.5 million relating to other restructuring related costs. We continue efforts to find ways to increase efficiencies and maximize synergies resulting from the Merger. In the event of future decisions involving charges of additional expenses, these expenses will be recorded when the decisions are made and the related costs can be estimated.

Impact of Phantom Options

During 2002, Elbit Systems' share price changed from a NASDAQ closing price of $18.50 at the end of 2001 to $16.04 at the end of 2002. The "phantom" stock options issued to employees in 2000 are accounted for as part of a "variable" stock option plan, with the total benefit of unexercised options re-measured at the end of each reporting period based on the share price on that date. See Note 17 D-F (Phantom Share Options) to the Financial Statements . As a result of this change in the share price, the effect of the share price linked compensation on the gross profit in 2002 was not material. The price of our shares may continue to affect net income in the future as long as a substantial number of phantom options remain unexercised

Summary of Financial Results

The following table sets forth the consolidated income statement of Elbit Systems and its subsidiaries for the periods listed. The consolidated financial results for the year ended December 31, 2000 include results of the activities of El-Op starting in the third quarter of 2000.

	For the year ended December 31 (In thousands of U.S. dollars exept per share data)					
	2002		**2001**		**2000**	
	$	**%**	**$**	**%**	**S**	**%**
Total revenues	$827,456	100.0	764,501	100.0	591,084	100.0
Cost of revenues	605,313	73.2	553,957	72.5	432,786	73.2
Restructuring expenses (inventories write-off)	—	—	—	—	10,300	1.8
Gross profit	**222,143**	**26.8**	**210,544**	**27.5**	**147,998**	**25.0**
Research and development expenses, net	57,010	6.9	58,759	7.7	44,274	7.5
Marketing and selling expenses	65,691	7.9	54,876	7.2	38,449	6.5
General and administrative expenses	41,651	5.0	43,216	5.7	26,251	4.4
Acquired in-process research and development	—	—	—	—	40,000	6.8
Restructuring costs	—	—	—	—	11,800	2.0
	164,352	**19.9**	**156,851**	**20.5**	**160,774**	**27.2**
Operating income (loss)	**57,791**	**7.0**	**53,693**	**7.0**	**(12,776)**	**(2.2)**
Finance income (expenses), net	(3,035)	(0.4)	(2,617)	(0.3)	115	0.0
Other income (expenses), net	(462)	(0.1)	774	0.1	3	0.0
Income (loss) before income taxes	**54,294**	**6.6**	**51,850**	**6.8**	**(12,658)**	**(2.1)**
Taxes on income	9,348	1.1	11,003	1.4	6,227	1.1
	44,946	**5.5**	**40,847**	**5.3**	**(18,885)**	**(3.2)**
Minority interest	(508)	(0.1)	547	0.1	(217)	(0.1)
Company's share of affiliated companies and partnership income (losses)	675	0.1	(598)	(0.1)	(1,429)	(0.2)
Net income (loss)	**$45,113**	**5.5**	**$40,796**	**5.3**	**$(20,531)**	**(3.5)**
Diluted earnings (loss) per share	**$1.13**		**$1.04**		**$(0.65)**	
Weighted average number of shares used in computation (in thousands)	**39,863**		**39,359**		**31,572**	

Non – U.S. GAAP Disclosure

The following table sets forth Elbit Systems' results of operations, excluding the non-recurring charge of $9.8 million (pre-tax) related to the agreement between El-Op and the OCS signed in the second quarter of 2002, the tax adjustment in 2002, the amortization of goodwill in 2001 and 2000 and restructuring expenses and acquired in-process research and development in 2000.

	For the year ended December 31 (In thousands of U.S. dollars exept per share data)					
	2002		2001		2000	
	$	%	$	%	$	%
Gross profit as reported	**222,143**	**26.8**	**210,544**	**27.5**	**147,998**	**25.0**
Goodwill amortization in 2001 and 2000	-	-	800	0.1	600	0.2
Restructuring expenses in 2000	-	-	-	-	10,300	1.7
OCS charge	9,801	1.2	-	-	-	-
Gross profit excluding OCS charge and goodwill amortization	**231,944**	**28.0**	**211,344**	**27.6**	**158,898**	**26.9**
Operating profit (loss) as reported	**57,791**	**7.0**	**53,693**	**7.0**	**(12,776)**	**(2.2)**
Goodwill amortization in 2001 and 2000	-	-	2,760	0.4	2,012	0.4
Restructuring expenses and acquired in-process research and development in 2000	-	-	-	-	62,100	10.5
OCS charge	9,801	1.2	-	-	-	-
Operating profit excluding OCS charge and goodwill amortization	**67,592**	**8.2**	**56,453**	**7.4**	**51,336**	**8.7**
Net earnings (loss) as reported	**45,113**	**5.5**	**40,796**	**5.3**	**(20,531)**	**(3.5)**
Goodwill amortization in 2001 and 2000	-	-	2,760	0.4	2,012	0.4
Restructuring expenses and acquired in-process research and development	-	-	-	-	56,800	9.6
Tax adjustment	(2,800)	(0.3)	-	-	-	-
OCS charge	7,840	0.9	-	-	-	-
Net earnings excluding OCS charge, goodwill amortization in 2001 and tax adjustment	**50,153**	**6.1**	**43,556**	**5.7**	**38,281**	**6.5**
Earnings (loss) per share as reported	**1.13**		**1.04**		**(0.65)**	
Goodwill amortization in 2001 and 2000	-		0.07		0.06	
Restructuring expenses and acquired in-process research and development in 2000	-		-		1.80	
Tax adjustment	(0.07)		-		-	
OCS charge	0.20		-		-	
Diluted earnings per share excluding OCS charge, goodwill amortization and tax adjustment	**1.26**		**1.11**		**1.21**	

2002 COMPARED TO 2001

Revenues

Our revenues increased from $764.5 million in 2001 to $827.5 million in 2002.

Our revenues generated by groups of areas of operations in 2001 and 2002 were as follows:

	2001	2002
	(U.S. dollars in millions)	
Fixed wing, helicopter and helmet mounted systems	334.2	372.8
UAVs, tactical, security, ground C4I and battlefield systems	105.8	122.7
Combat vehicles systems	126.3	135.7
Electro-optics systems	162.7	148.1
Others	35.5	48.2
Total	**764.5**	**827.5**

Revenues increased in 2002 mainly in fixed wing, helicopter and helmet mounted systems, which increased by $38.6 million and in UAV, tactical, security, ground C4I and battlefield systems, which increased by $16.9 million.

The geographic breakdown of revenues in 2001 and 2002 was as follows:

	2001	2002
Israel	30%	27%
United States	27%	32%
Europe	23%	18%
Other countries	20%	23%

We sell mainly to governmental entities and prime contractors under government defense programs. Accordingly, the level of our revenues is subject to governmental budgetary constraints.

Revenues are generated mainly from sales to the United States, Israel, and countries in Europe, Latin America and Asia. The recent economic situation in Israel has created some uncertainty with respect to the Israeli Government general and defense budgets.

Revenues in the United States increased by 29.6%, from $206.6 million to $267.7 million. Revenues also increased in Other Countries, mainly in Latin America and Asia, while revenues in Europe declined as deliveries under some major programs entered final phases. In Israel, we were able to maintain our revenue level in 2002, despite of the budgetary pressures faced by the Israeli Ministry of Defense (IMOD).

Gross Profit

Reported gross profit in 2002 was $222.1 million (gross profit margin of 26.8%) as compared to $210.5 million (gross profit margin of 27.5%) in 2001.

Gross profit included $9.8 million of non-recurring charges related to El-Op's program with the OCS in 2002, and $0.8 million of goodwill amortization in 2001. Excluding these charges, the gross profit and gross profit margin in 2002 were $231.9 million and 28.0%, respectively, as compared to $211.3 million and 27.6%, respectively in 2001.

Gross profit in 2001 included expenses of $2.9 million related to Elbit Systems' share price linked compensation costs. The effect of the share price linked compensation on the gross profit in 2002 was not material.

As noted above, our gross profit for 2002 was also affected by the write-off in the amount of approximately $6.3 million in the second quarter of 2002 relating to Cyclone's project with Dornier.

Research and Development (R&D)

We continually invest in R&D in order to maintain and further advance our technologies, in accordance with a long-term plan, based on our estimate of future market needs.

Gross R&D expenses in 2002 totaled $62.6 million (7.6% of revenues), as compared with $67.9 million (8.9% of revenues) in 2001. The decrease in R&D expenses as a percentage of revenues was caused mainly by a different mix of R&D work we performed under customer funded and internally funded R&D projects, as well as a result of our continued efforts to increase the efficiency of our R&D operations.

Net R&D expenses (after deduction of the OCS participation) in 2002 totaled $57.0 million (6.9% of revenues), as compared to $58.8 million (7.7% of revenues) in 2001.

In 2001, the OCS issued its new "Regulations for the Encouragement of Research and Development in Industry" (rules for determining the level and payment of royalties). The regulations allow large R&D intensive companies to reach certain agreements with the OCS regarding determination of the amount and payment schedule of royalties, subject to certain conditions. El-Op elected to join the program. As of the date of this report, Elbit Systems has not yet determined whether to join the OCS's new program.

The OCS's participation in our R&D expenses in the 2002 was lower than in 2001. We estimate that the level of participation by the OCS in the future may be affected by changes in the OCS budget, as well as in our R&D programs.

Marketing and Selling Expenses

Marketing and selling expenses in 2002 were $65.7 million (7.9% of revenues), as compared to $54.9 million (7.2% of revenues) in 2001.

Our marketing and selling expenses increased in 2002 as compared to 2001 mainly due to the need to invest a higher level of resources in generating new business and the increased length of time required for marketing efforts until orders are received. In addition, we continue to invest in expanding into new markets.

General and Administrative (G&A) Expenses

Reported G&A expenses in 2002 were $41.7 million (5.0% of revenues), as compared to $43.2 million (5.7% of revenues) in 2001.

Due to changes in Elbit Systems' share price in the reported periods, our G&A expenses included share price linked compensation expenses of $5.2 million in 2001, while in 2002 these expenses were not material. Excluding goodwill amortization and share price linked compensation, our G&A expenses in 2001 were $36.0 million. We expect that G&A expenses may continue to be affected in the future, due to changes in Elbit Systems' share price.

As stated above, following the adoption of SFAS 142 effective January 1, 2002, we no longer amortize goodwill. In 2001, G&A expenses included amortization of goodwill of approximately $2.0 million.

G&A expenses in 2002 included $2.8 million in amortization of intangible assets related to activities and companies that were not consolidated in the same period last year, including mainly the equity interest in AEL in Brazil and the business of the Elron Telesoft Government Division in Israel, which we acquired in the second half of 2001 and in January 2002, respectively.

Operating Income

As a result of all of the above, reported operating income in 2002 was $57.8 million (7.0% of revenues), as compared to $53.7 million (7.0% of revenues) in 2001.

Excluding the non-recurring charge related to El-Op's OCS program in 2002 and goodwill amortization in 2001, our operating income and operating margin in 2002 (as a percentage of revenues) were $67.6 million and 8.2%, respectively, compared to $56.5 million and 7.4% in the comparable period in 2001.

The operating profit in 2001 included share price linked compensation expenses of $9.1 million.

In 2002, we had income related to share price linked compensation that was not material.

We expect that operating income may continue to be affected in the future by changes in our share price due to our share price linked compensation program.

Finance Expense (Net)

Net finance expense in 2002 was $3.0 million, as compared to $2.6 million of net finance expense in 2001.

The increase in the net finance expense resulted mainly from the increased financing we required due to the higher level of its revenues, operating assets and investments.

Taxes on Income

Provision for taxes for 2002 was approximately $9.3 million, as compared to a provision for taxes of $11.0 million in 2001.

The provision for taxes in 2002 included reduction of tax expenses in the amount of $2.8 million that was made in the third quarter of 2002, due to adjustment of estimated taxes and completion of tax assessments for prior years in respect of various Elbit Systems' group companies.

Our effective tax rate in 2002 was 17.2%, as compared to 21.2% in 2001. Excluding the tax reduction mentioned above, our tax rate for 2002 would have been 22.4%, due mainly to the mix of the tax rates in the various tax jurisdictions in which the group's companies generating the taxable income operate, since our tax rate represents the group's weighted average tax rate.

Net Earnings and Earnings Per Share (EPS)

Reported net earnings in 2002 were $45.1 million (5.5% of revenues), as compared to reported net earnings of $40.8 million (5.3% of revenues) in 2001. Reported fully diluted EPS was $1.13 in 2002, as compared to $1.04 in 2001.

Net earnings in 2002, excluding non-recurring charges related to the OCS program and prior years tax adjustments, were $50.2 million (6.1% of revenues), as compared to $40.8 million (5.3% of revenues) in 2001. Excluding these charges and adjustments, diluted EPS was $1.26 in 2002.

Excluding amortization of goodwill, net earnings and diluted EPS in 2001 were $43.6 million and $1.11, respectively.

Net earnings in 2001 included $7.1 million in expenses related to share price linked compensation. In 2002 we had income related to share price linked compensation that was not material.

The number of shares used for computation of diluted EPS in 2002 and 2001 was approximately 39.9 million shares and 39.4 million shares, respectively. The increase in the number of shares was due mainly to the exercise of options during the period.

LIQUIDITY AND CAPITAL RESOURCES

Cash Flow. Our cash flow represents the cumulative cash flow of our various projects in the reported periods. Project cash flows are affected by the timing of the receipt of advances and the collection of accounts receivable from customers. These relate to specific events during the project, while expenses are ongoing. Our policy is to invest our cash surplus mainly in interest bearing short and long-term deposits, in accordance with our projected needs.

Financial Resources. The financial resources available to us include profits, collection of accounts receivable, advances from customers and Government of Israel programs such as OCS and development grants. In addition, Elbit Systems has access to bank credit lines in Israel and abroad based on our capital, assets and activities. We also have the possibility of raising funds through offering of shares to the public from time to time subject to market conditions. For further information on the level and maturity of our borrowings, see Note 10 (Short-Term Bank Credit and Loans) and Note 13 (Long-Term Loans) to the Financial Statements. In our opinion our working capital is sufficient to support our current requirements.

2002 Cash Flow

Our net cash flow generated from operating activities in 2002 was $116.0 million, resulting mainly from net income for the period, receipt of advances from customers and collection of accounts receivables. The cash inflows were partially offset, mainly by increase in inventories and payment of trade payables.

Net cash flow used for investment activities in 2002 was $51.0 million, which was used mainly for procurement of property, plant and equipment, as well as other assets. During 2002, we invested $22.1 million in equipment for our various manufacturing plants, and $13.2 million in buildings, mainly those being built at Elbit Systems' site in Haifa, Israel and El-Op's site in Rehovot, Israel. These buildings are planned to house employees currently located in various leased locations in the industrial parks in which the respective companies are located.

Net cash flow used for financing activities in 2002 was $29.3 million, which was used mainly for reduction of short and long-term borrowings and payment of $12.7 million in dividends during 2002.

On December 31, 2002, we had total bank borrowings in the amount of $104.1 million, including $73.2 million in long-term loans, and $374 million in guarantees issued on our behalf by banks, mainly as advance payment and performance guarantees in the regular course of business. On December 31, 2002, we had cash balances amounting to $77.9 million.

As of December 31, 2002, we had working capital was $197.6 million, and our current ratio was 1.54. Our ratio of equity to total assets was 44%.

2001 Cash Flow

Our net cash flow from operating activities in 2001 was $41.2 million, resulting mainly from net earnings and an increase in accounts payable, other payables, and advances from customers, which was partly offset by an increase in inventories and accounts receivable.

Net cash flow used in investing activities in 2001 was $44.7 million, which was used mainly for procurement of fixed assets.

Net cash flow used in financing activities in 2001 was $6.7 million, which was used mainly for repayment of debts and dividend payments. The use of funds was partly offset by receipt of new long-term debt.

On December 31, 2001, we had working capital of $120.9 million, our current ratio was 1.31 and our equity ratio was 41.9%.

Material Commitments for Capital Expenditures. We believe that we have adequate sources of funds to meet our material commitments for capital expenditures for the fiscal year ended December 31, 2002 and the subsequent fiscal year. Our specific material commitments for capital expenditures as of December 31, 2002 and May 31, 2003 were approximately $28 million and $25 million respectively. These commitments were mainly for the new building projects in Haifa and Rehovot. See also the Consolidated Statements of Cash Flows and Note 8 (Property, Plant and Equipment) to the Financial Statements.

IMPACT OF INFLATION AND EXCHANGE RATES

Functional Currency. Our functional currency is the U.S. dollar, which is the currency we use for most of our consolidated operations. A majority of our sales are made outside of Israel in non-Israeli currency, mainly U.S. dollars, as are a majority of our purchases of materials and components. Transactions and balances originally denominated in U.S. dollars are presented in their original amounts. Transactions and balances in currencies other than the U.S. dollar are remeasured in U.S. dollars according to the principles set forth in Statement No. 52 of the Financial Accounting Standards Board. Exchange gains and losses arising from remeasurement are reflected in the income statement. Balances linked to the CPI are stated using the latest index published prior to the balance sheet date.

NIS/U.S. Dollar Exchange Rates. We attempt to manage our financial activities in order to reduce material financial losses in U.S. dollar terms resulting from the impact of inflation and exchange rate fluctuations on our non-U.S. dollar assets and liabilities. Our income and expenses in Israeli currency are translated into U.S. dollars at the prevailing exchange rates. Consequently, we are affected by changes in the NIS/U.S. dollar exchange rates. On December 31, 2002, we had exposure due to NIS denominated liabilities of $46 million in excess of NIS denominated assets.

Inflation and Devaluation

The U.S. dollar cost of our operations in Israel is influenced by any increase in the rate of inflation in Israel that is not fully offset by the devaluation of the NIS in relation to the U.S. dollar. Unless inflation in Israel is offset by a devaluation of the NIS, it will have a negative effect on the profitability of contracts where Elbit Systems or any of our Israeli subsidiaries receives payment in U.S. dollars, NIS linked to U.S. dollars or other foreign currencies, but incurs expenses in NIS linked to the CPI. Inflation in Israel and currency fluctuations will also have a negative effect on the profitability of fixed price contracts where we receive payments in NIS.

In the past, our profitability was somewhat negatively affected when inflation in Israel exceeded the devaluation of the NIS against the U.S. dollar and at the same time we experienced corresponding increases in the U.S. dollar cost of our operations in Israel. For example, in 1998, the rate of inflation was 8.6% and the devaluation rate was 17.6%. However, in 1999 the rate of inflation was approximately 1.3% and the rate of devaluation was -0.2%. In 2000, the rate of inflation was approximately 0% and the devaluation rate was -2.7%. In 2001 the inflation rate was approximately 1.4% and the devaluation rate was 9.3%. In 2002, the inflation rate was approximately 6.5% and the devaluation rate was 7.3%. There can be no assurance that we will not be materially adversely affected in the future if inflation in Israel exceeds the devaluation of the NIS against the U.S. dollar or if the timing of such devaluation lags behind increases in inflation in Israel.

A devaluation of the NIS in relation to the U.S. dollar also has the effect of decreasing the dollar value of any of our assets that consist of NIS or accounts receivable denominated in NIS, unless such accounts receivable are linked to the U.S. dollar. Such a devaluation also has the effect of reducing the U.S. dollar amount of any of our liabilities that are payable in NIS, unless such payables are linked to the U.S. dollar. On the other hand, any increase in the value of the NIS in relation to the U.S. dollar will have the effect of increasing the U.S. dollar value of any unlinked NIS assets as well as the U.S. dollar amount of any unlinked NIS liabilities and expenses.

Foreign Currency Expenses

While our functional currency is the U.S. dollar, we also have some non-U.S. dollar or non-U.S. dollar linked currency exposure for currencies other than NIS. These are mainly non-U.S. dollar customer debts, payments to suppliers and subcontractors, obligations in other currencies, assets or undertakings. Some subcontractors are paid in local currency under prime contracts where we are paid in U.S. dollars. The exposure on these transactions has not been in amounts that are material to Elbit Systems. However, when we view it necessary, we seek to minimize our foreign currency exposure, by entering into hedging arrangements, obtaining periodic payments upon the completion of milestones, obtaining guarantees and security from customers and sharing currency risks with subcontractors. Gains and losses on forward exchange contracts entered as hedges are recognized currently.

Most of our assets and liabilities that are denominated in currencies other than the NIS and the U.S. dollar were covered as of December 31, 2002 by financial instruments (mostly forward contracts). On December 31, 2002, we had contracts for the sale and purchase of such foreign currencies totaling $21.4 million. The results of financial derivative activities were not material.

Impact of the Euro. We conduct activities in a number of the countries that have adopted the European Monitory Unit (EURO). To date, the transition to the use of the EURO in the relevant countries has not resulted in a material exposure to us.